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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY — DOCKET NO. E-01933A-98-0471

IN THE MATTER OF THE FILING OF TUCSON ELECTRIC POWER COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C.R14-2-1601 et seq. — DOCKET NO. E-01933A-97-0772

IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA — DOCKET NO. RE-00000C-94-0165

Arizona Corporation Commission
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NOTICE OF FILING

The Department of Defense (the "DOD") hereby files the original and ten (10) copies of the direct testimony of Dan L. Neidlinger on the proposed Settlement Agreement ("Agreement") between the ACC Staff and Tucson Electric Power Company ("TEP") with reference to the above dockets. Copies of this testimony have been faxed and mailed to the attached Service List.

Respectfully submitted this 30th day of November, 1998.

Sincerely,

Peter Q Nyce, Jr /DLN

Peter Q. Nyce Jr.
General Attorney
Regulatory Law Office
United States Army Legal Services Agency
901 North Stuart Street
Arlington, VA 22203-1837

BEFORE THE ARIZONA CORPORATION COMMISSION

PROPOSED SETTLEMENT AGREEMENT ("AGREEMENT") BETWEEN THE STAFF OF THE ACC AND TUCSON ELECTRIC POWER COMPANY ("TEP")

DOCKET NO. E-019133A-98-0471, et al.

Direct Testimony of Dan L. Neidlinger

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Dan L. Neidlinger. My business address is 3020 North 17th Drive, Phoenix, Arizona. I am President of Neidlinger & Associates, Ltd., a consulting firm specializing in utility rate economics.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS AND EXPERIENCE.

A. A summary of my professional qualifications and experience is included in the attached Statement of Qualifications. In addition to the Arizona Corporation Commission ("ACC" or the "Commission"), I have presented expert testimony before regulatory commissions and agencies in Alaska, Colorado, Guam, Idaho, New Mexico, Nevada, Texas, Utah, Wyoming and the Province of Alberta, Canada.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the interests of the United States Department of Defense, and all other Federal Executive Agencies (hereinafter referred to as the "DOD"). The DOD facilities affected by the proposed Agreement in this proceeding are Fort Huachuca, located near Sierra Vista, Arizona and Davis-Monthan Air Force Base in Tucson. Both of these installations currently receive service from TEP under Rate Schedule 14, the Large Light & Power rate.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to discuss certain provisions of the proposed Agreement between the ACC Staff and TEP. More specifically, my testimony addresses the anticompetitve aspects of the Agreement, the conflicts between the Agreement and the Commission's generic decision on stranded costs, Decision No. 60977, and the imbalance with respect to the interests of TEP's customers.

Q. HAVE YOU BEEN PROVIDED ADEQUATE TIME IN THIS CASE TO ANALYZE AND REVIEW THE DETAILS OF THE PROPOSED AGREEMENT?

A. No. In past rate proceedings for TEP, a period of four to six months would normally be provided to conduct discovery, analyze in depth all aspects of the rate proposal and to prepare direct testimony. In this case, a case that involves decisions on dollar amounts that are conceivably 15 to 20 times greater than any prior rate proceeding, intervenors have been provided only a few days to complete the same activities. The apparent prejudicial provisions of the Agreement have been extended to the hearing process.

Q. HAVE YOU REACHED ANY CONCLUSIONS BASED ON YOUR LIMITED REVIEW?

A, Yes. My conclusions are as follows:

1.) The Agreement will not provide for any meaningful competition in Arizona;
2.) TEP's interim transition charge ("ITC") will recover millions of dollars that are not stranded costs;
3.) TEP's Market Generation Credit ("MGC") adder is not a pure market adder, in contrast with the adder proposed by Arizona Public Service Company ("APS");
4.) The Agreement does not provide for a balancing of interests of stakeholders, as required by Decision No. 60977; and
5.) The Agreement could result in the recovery from TEP's ratepayers of more than 100% of TEP's stranded costs.

Q. STAFF WITNESS WILLIAMSON IMPLIES ON PAGE 2 OF HIS PREPARED TESTIMONY THAT THE AGREEMENT WILL "FOSTER THE DEVELOPMENT OF ROBUST AND MEANINGFUL COMPETITION AT THE EARLIEST POSSIBLE DATE". DO YOU AGREE?

A. No. TEP's proposed methodology for calculating ITCs will provide an effective barrier for competition for at least two years. Under the Generation Rates ("GRs") proposed by TEP for Rate 14 customers and using its ITC calculation method, Fort Huachuca's direct access total charges would be approximately 7 cents per kilowatt-hour ("KWH") for the first quarter of 1999 in contrast with the 6.3 cents per KWH that would be experienced under TEP's standard offer Rate 14.. This would represent an 11% increase in the Fort's power bill for this period.

Q. APS WITNESS DAVIS HAS ASSUMED THAT THE AVERAGE MARKET PRICE FOR POWER IN 1999 WILL BE 2.6 CENTS PER KWH. WHAT WOULD BE THE EFFECT OF THE FORT'S ANNUAL 1999 BILL AS A DIRECT ACCESS CUSTOMER UNDER THIS ASSUMPTION?

A. Under Mr. Davis's assumption that the market price of power for 1999 will average 2.6 cents per KWH, the Fort's annual bill under direct access would be approximately $647,000 or 9.8% greater than the bill under the standard offer rate.

Q. WHAT DO YOU CONCLUDE FROM THIS ANALYSIS?

A. I conclude that the Fort will be unable to compete its load beginning in 1999 since alternative power suppliers will be unable to even match, let alone beat, TEP's current standard offer rate.

Q. WILL ALTERNATIVE ENERGY SERVICE PROVIDERS ("ESPs") BE ANXIOUS TO COMPETE IN TEP'S SERVICE TERRITORY UNDER THIS AGREEMENT?

A. No. It is unlikely, in my view, that alternative ESPs will interested in bidding on any of TEP's current loads under the proposed direct access ratemaking scheme since there is little opportunity to provide the customer with lower power bills. Since APS's proposed ITC calculation is comparable to TEP's, from an end result perspective, a similar response (non-response) may be experienced by customers in APS's service territory. Under TEP's proposed method for calculating ITCs, there will be no meaningful competition for at least two years.

Q. THE COMMISSION HAS PROCLAIMED TIME AND AGAIN THAT IT WANTS COMPETITION IN ARIZONA BEGINNING JANUARY 1, 1999. HOW CAN THIS BE ACHIEVED IN TEP'S SERVICE AREA?

A. Competition can become a reality beginning in 1999 if TEP's proposed GRs are reduced to levels that approximate, on an interim basis, TEP's stranded generation costs. As discussed later, the recalculation of TEP's GRs could push forward the targeted January 1, 1999 date to February or March of 1999.

Q. HOW WERE TEP'S GRs DEVELOPED?

A. The GRs were developed by deducting allocated distribution and transmission costs from average, currently approved, standard offer rates. They produce ITCs that are not even a reasonable facsimile of TEP's stranded costs. One would expect to see a calculation methodology, for instance, that produces an ITC at or near the 1.8 cents per KWH permanent CTC shown on Schedule 4 of TEP's Stranded Cost Filing. Instead, TEP's ITCs for Rate 14 customers will probably be in the range of 2.5 to 2.8 cents except during one or two summer months. Assuming Mr. Davis's average market price of 2.6 cents for 1999, TEP's ITC for Rate 14 customers averages 2.7 cents.

Q. DID TEP OR THE ACC STAFF ATTEMPT TO IDENTIFY OR ESTIMATE TEP'S STRANDED COSTS ON AN INTERIM BASIS AND ALLOCATE THESE COSTS IN ACCORDANCE WITH DECISION NO. 60977?

A. No. The proposed GR for Rate 14 customers, for instance, is 5.78 cents per KWH. As previously discussed, this rate is a calculated amount with no underpinnings from a cost of service standpoint. It was developed using a multiple timeframes for the determination of class allocation factors, FERC jurisdictional allocations, operating expenses and class billing units. It is impossible to tie or reconcile the costs included in the 5.78 cent GR to defined time period or to TEP's accounting records. There was no attempt made by TEP or the Staff to estimate TEP's current stranded generation costs and allocate them in accordance with Decision No. 60977. It is clear, however, that the 5.78 cent GR includes tens of millions of dollars of costs, including general and administrative costs, that are not stranded costs. Accordingly, TEP's proposed GRs are excessive and produce ITCs that are overstated.

Q. ASSUMING THAT 1.8 CENTS PER KWH IS A REASONABLE ESTIMATE OF TEP'S STRANDED COSTS, WHAT IS THE MAGNITUDE OF THE OVERCOLLECTIONS UNDER TEP'S PROPOSED ITCS FOR TEP'S INDUSTRIAL CUSTOMERS?

A. If 1.8 cents per KWH is assumed as a reasonable proxy for TEP's stranded costs, the annual overcollections of stranded costs under TEP's proposed ITCs range from $17 to $20 million for Large Light & Power Customers, including special contracts. Direct access overcharges for stranded costs to Fort Huachuca are in the range of $700,000 to $1,000,000 annually under this assumption. Since ESPs will not absorb these excessive charges, there will be no competitive marketplace for these large customers. These facts totally contradict the notion that the "big dogs will eat first and eat well".

Q. HOW SHOULD THIS DEFICIENCY BE CORRECTED?

A. First, I suggest that the Commission abandoned the "not too high, not too low, but just right" approach for setting MGCs advocated by Staff witness Smith. There is too much at stake to be tweaking and "fiddling" with these credit amounts to achieve a preconceived outcome. I might add, it is not clear from either Mr. Smith's testimony or Mr. Williamson's testimony how they view that outcome. Next, TEP's GRs should be recalculated by estimating TEP's stranded generation costs using 1998 rate base and operating expenses and allocating these costs to customer classes based on the allocation methodology prescribed in Decision No. 60977. As previously mentioned, the result of this recalculation should be at or near the estimated 1.8 cents per KWH permanent CTC provided in TEP's stranded cost filing. This additional analysis could be completed in January, 1999 and would delay the initiation of competition by only two to three months.

Q. SHOULD THE RECALCULATION OF TEP'S GRS INCLUDE A RECALCULATION OF TRANSMISSION COSTS?

A. Yes. TEP's cost of ancillary transmission services should be segregated in the cost allocation and not included in its GRs. APS's proposed market "adder" for high load factor customers is pure market adder of 2.7 mills per KWH compared with TEP's 2.6 mills. TEP's adder, however, is for ancillary transmission services and not a pure market adder. Since Fort Huachuca's ancillary transmission costs are approximately 1.7 mills per KWH, the effective pure market adder for the Fort is only 0.9 mills. The Commission should be consistent in the manner in which these adders are calculated and applied if it wishes to encourage competition through this mechanism.

Q. DOES THE AGREEMENT PROVIDE FOR A BALANCING OF INTERESTS OF THE VARIOUS STAKEHOLDERS?

A. No, it does not. Finding No. 26 of Decision No. 60977 states: "Any stranded cost recovery methodology must balance the interests of Affected Utilities, ratepayers, and a move toward competition." The Agreement is completely contrary to this finding since none of the interests of the ratepayers have been considered. The recent minor rate concessions provided by TEP are not part of this Agreement but authorized pursuant to another Commission decision. Further, the Agreement is in conflict with Finding No. 18 which states: "Affected Utilities should have a reasonable opportunity to collect 100 percent of their unmitigated stranded costs." and Finding No. 20 which states: "Traditional regulation does not guarantee 100 percent recovery of costs but only a reasonable opportunity to recover costs." The Agreement essentially provides a guarantee that all stranded costs will be recovered from the ratepayers. The traditional ratemaking concept of "reasonable opportunity" has been abandoned.

Q. DOES THE AGREEMENT REQUIRE TEP TO UNDERTAKE SPECIFIC ACTIONS TO MITIGATE STRANDED COSTS?

A. No, it does not. The Agreement is silent with respect to stranded cost mitigation efforts mandated on TEP other than a partial divestiture of its generation assets. The Agreement assures that TEP will fully recover all costs, prior to divestiture, through standard offer rates or the ITCs.

Q. WHAT ABOUT THE PROVISION TO GIVE TEP THE FIRST 35% OF ANY NEGATIVE STRANDED COSTS RESULTING FROM THE DIVESTITURE OF GENERATION ASSETS?

A. This is another example of a complete disregard for the interests of TEP's ratepayers -- blatant discrimination. In all fairness, TEP should be required to absorb the first 35% of any positive stranded costs resulting from divestiture activities. Another "heads I win, tails you lose" provision.

Q. WHAT ABOUT THE PROPOSED SWAP OF TEP'S NAVAJO AND FOUR CORNERS GENERATING FACILITIES FOR SOME OF APS'S TRANSMISSION FACILITIES AT BOOK VALUE?

A. I have not had time to evaluate in detail this proposed swap. However, in all likelihood, the Navajo and Four Corners facilities would auction at a premium over book value whereas the Springerville generating facilities may not realize a premium. Should this be the case, TEP would recover more than 100% of its stranded costs unless and adjustment is made to reflect the premiums that would accrue from the auctioning of the Navajo and Four Corners facilities.

Q. DO YOU HAVE ANY CONCLUDING COMMENTS?

A. Yes. In summary, it is my view that the proposed Agreement fails to accomplish any of the Commission's stated objectives in this endeavor such as the development of robust competitive market, a "level playing field" for all participants or a balancing of interests of the stakeholders. The Commission should not be hurried into making a decision involving hundreds of millions of dollars that will affect TEP's ratepayers for the next 10 years. It should take the time needed to evaluate in depth every aspect of the Agreement. There is not adequate time between now and December 31st to conduct a prudent and thorough investigation.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

DAN L. NEIDLINGER

SUMMARY STATEMENT OF QUALIFICATIONS

I. General:

Mr. Neidlinger is President of Neidlinger & Associates, Ltd., a Phoenix consulting firm specializing in utility rate economics and financial management. During his consulting career, he has managed and performed numerous assignments related to utility ratemaking and energy management.

II. Education:

Mr. Neidlinger was graduated from Purdue University with a Bachelor of Science degree in Electrical Engineering. He also holds a Master of Science degree in Industrial Management from Purdue's Krannert Graduate School of Management. He is a licensed Certified Public Accountant in Arizona and Ohio.

III. Consulting Experience:

Mr. Neidlinger has presented expert testimony on financial, accounting, cost of service and rate design issues in regulatory proceedings throughout the western United States involving companies from every segment of the utility industry. Testimony presented to these regulatory agencies has been on behalf of commission staffs, applicant utilities, industrial intervenors and consumer agencies. He has also testified in a number of civil litigation matters involving utility ratemaking and once served as a Special Master to a Nevada court in a law suit involving a Nevada public utility.

Mr. Neidlinger has performed numerous feasibility studies related to energy management including cogeneration, self-generation, peak shaving and load-shifting analyses for clients with large electric loads. In addition, he has conducted electric and gas privatization studies for U. S. Army installations and assisted these and other consumer clients in contract negotiations with utility providers of electric, gas and wastewater service.

Mr. Neidlinger has extensive experience in the costing and pricing of utility services. During his consulting career, he has been responsible for the design and implementation of utility rates for over 30 electric, gas, water and wastewater utility clients ranging in size from 50 to 25,000 customers.

IV. Professional Affiliations:

Professional affiliations include the American Institute of Certified Public Accountants and the Association of Energy Engineers.